

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of)	
)	
Connect America Fund)	WC Docket No. 10-90
)	
High-Cost Universal Service Support)	WC Docket No. 05-337

COMMENTS OF ALASKA COMMUNICATIONS SYSTEMS

Alaska Communications Systems (“ACS”)¹ hereby submits these comments in response to the publication by the Wireline Competition Bureau (“Bureau”) in the Federal Register, “Wireline Competition Bureau Seeks Additional Comment in Connect America Cost Model Virtual Workshop,”² in which it seeks comment on questions relating to modeling voice capability and Annual Charge Factors (“ACFs”), focusing on the Connect America Cost Model (“CACM”) version two. ACS responds to three of the four sets of questions posed in the Public Notice.

Question 1. Is it reasonable to model voice capability on a per-subscriber basis? Are there any alternative ways to model the cost?

It is reasonable to model the requirements for providing voice capability over broadband facilities on a per-subscriber basis, provided cost differences between study areas are taken into account. ACS expects that the same per-subscriber costs generally will be applicable to each location in a given ILEC study area, but will vary between study areas. This is the case in Alaska, where ACS serves six study areas each with different cost-causative features. For

¹ In these comments, ACS signifies the four incumbent local exchange carrier (“ILEC”) subsidiaries of Alaska Communications Systems Group, Inc.: ACS of Alaska, LLC, ACS of Anchorage, LLC, ACS of Fairbanks, LLC, and ACS of the Northland, LLC.

² 78 Fed. Reg. 12271 (Feb. 22, 2013), referencing *Wireline Competition Bureau Seeks Additional Comment in Connect America Cost Model Virtual Workshop*, Public Notice, DA 13-156 (Wireline Competition Bur., rel. Feb. 5, 2013) (“Public Notice”).

example, ACS serves 54,000 customers from 12 wire centers in the Anchorage study area, while it serves 9,000 customers from 50 wire centers in the Sitka study area; 49 out of the 50 Sitka wire centers are linked by either satellite or terrestrial point-to-point microwave transport – no fiber facilities are available – to the Anchorage point-of-presence (“POP”) for local interconnection and long-distance access. Thus, the per-subscriber costs for voice capability vary widely between the Sitka and Anchorage study areas.

The model must accurately predict the cost of providing voice and broadband capability in a given geographic area, reflecting the specific requirements dictated by the service territory.³ Any model that estimates per-subscriber costs for voice capability therefore must include location-specific costs for switching, which is an integral aspect of providing voice services. CACM Version Two (“CACM V2”) does not capture all necessary inputs to appropriately reflect the switching costs involved in serving customers in the six price cap study areas in Alaska. Specifically, the CACM has only one set of input values for switching that applies to every price cap carrier in the nation regardless of the number of soft switches installed and the number of customers served. It is not reasonable to assume that all ILECs, with varying constraints for providing voice service, each would have the same per-subscriber costs for voice capability. Switching costs in Alaska vary greatly from costs in the Lower 48 states, and even within the ACS family of companies. For example, in the Sitka study area, because wire centers are not connected by fiber to ACS’s other facilities, ACS cannot deploy a single softswitch to serve multiple locations (as assumed by the model) – the middle mile transport costs would be prohibitive. As another example of the cost of serving isolated Alaska bush communities, ACS

³ See *USF-ICC Transformation Order*, ¶188 (requiring the Bureau’s cost model to have geographic and cost-component granularity, “to capture the true costs of sub-scale markets”).

recently had to install a new switch to extend voice service to a subdivision of about 400 customer locations in Klawock, the cost of which exceeded \$750,000 for equipment and installation.

Voice capability costs can be estimated on a per-subscriber basis as long as these estimates account for the inherent differences between study areas. ACS has stressed before, and continues to stress here, that any methodology used to set support for the price cap ILECs serving Alaska must account for the unique characteristics and costs associated with serving study areas that are unlike any other place on Earth.⁴ Estimating voice capability costs is yet another example of how a single set of inputs cannot accurately estimate costs (and thereby set support) at a level of granularity required by the *USF/ICC Transformation Order*.⁵

Question 2. Are the specific inputs that CACM version 2 uses for the cost of voice capability reasonable? If proposing an alternative method, what specific sources and values should be used?

The inputs used in the CACM V2 are not reasonable to estimate the costs of voice capability. A model based on one set of input values for the entire nation cannot effectively estimate costs that vary significantly among regions and study areas, for example, based on the number of customer locations to be served and the facilities required to serve them. As discussed above, ACS serves some 49 Alaska Bush communities, which may have only a few

⁴ *Connect America Fund; High-Cost Universal Service Support*, Comments of Alaska Communications Systems, WC Docket Nos. 10-90 and 05-337 (filed Feb. 27, 2013) (“ACS Feb. 27 Comments”) (referencing *Connect America Fund*, Report and Order and Further Notice of Proposed Rulemaking, 26 FCC Rcd 17663, ¶ 188 (2011) (“*USF/ICC Transformation Order*”) (specifying that any model used to allocate CAF Phase II funding must accurately predict the forward-looking costs specific to the geographic area served by the ILEC receiving funding).

⁵ ACS Feb. 27 Comments at 6-7 (referencing *Connect America Fund; High-Cost Universal Service Support*, Reply Comments of Alaska Communications Systems Group, Inc., WC Docket Nos. 10-90 and 05-337, at 12 (filed July 23, 2012) (“ACS Model Design/Data Inputs Reply Comments”)).

customers per wire center and no ability to connect the wire centers via terrestrial facilities.

Inputs to the CACM should be specific to the study area being modeled. The inputs that will accurately reflect the costs of a carrier serving a medium or even a small sized market in the Lower 48 states will not accurately reflect the costs of a carrier serving a Bush community in Alaska.⁶

Beyond this, it is almost impossible for ACS to effectively analyze the reasonableness of the CACM values because ACS does not have access to the underlying spreadsheet, analyses or calculations that resulted in the values found in the Switching Tab of the Capex V9 file. Without access to the calculations used to develop the switching input values, the public cannot effectively participate in this evaluation. Moreover, ACS cannot fully evaluate the reasonableness of the input values without access to the model itself. For example, to provide useful analysis, ACS would need to know if the three values for each subscriber are summed together or if there is an algorithm that uses these values to calculate the per-subscriber cost, which is used in the CACM to calculate support amounts. ACS has stressed repeatedly that the model must be made more transparent, and this one example highlights the problems that arise from lack of transparency.

In its February 27 Comments, ACS summarized what it has stated on the record many times, specifically that the “CACM, like the CQBAT model before it, suffers from lack of transparency and inflexibility. The model cannot be thoroughly understood by the public without improved access to the mechanism and greater disclosure of the assumptions that

⁶ See ACS Feb. 27 Comments at 6. Carriers can provide CostQuest with updated input files and review the model output sets, but they cannot see how the updated inputs are manipulated within the model or whether the updated inputs are comparable to the CACM’s default input values.

underlie it. Moreover, it cannot be easily improved upon due to this inflexibility and lack of transparency. It is simply impossible to reproduce or validate the results of the CACM because the public does not have access to all the input development worksheets and the model's algorithms. Moreover, carriers impacted by the model do not have the ability to run the model in real time in order to assess the value of changes. Carriers can review the model output sets, but they are not given the ability to truly test the model. In short, without the ability analyze the underlying algorithms and input development, carriers are asked to trust the model as provided; they cannot verify it and they cannot effectively participate in the model development process.”⁷

Even lacking transparency, however, it is clear that the CACM applies a one-size-fits all standard with regard to input values and ACS believes these input values are understated. ACS's service and operations, in terms of numbers of customers, are magnitudes smaller than most of the coalition members that have supported the CQBAT and now the CACM. However, ACS's service territory is large and much of it is so remote that transport costs render the use of centralized switching infeasible. For example, ACS engineers have estimated the cost of placing soft switches in its service territory. The cost estimates were developed assuming that centralized soft switches would be placed in Anchorage, Fairbanks, Juneau, and Soldotna to serve wire centers in the state that could be connected by fiber with relative ease. However, dozens of other ACS wire centers rely on satellite or microwave transport and therefore require individual soft switches. Based on the analysis that ACS has been able to perform to date, the additional per-subscriber cost of switching used to estimate universal service support levels would greatly exceed the values currently found in the CACM and exhibit a wide variation

⁷ ACS Feb. 27 Comments at 8-9 (footnotes omitted).

between ACS serving areas. This result is not surprising given that the data used to develop the input values were not based on the cost factors so critical to ACS service.⁸

Question 4. Are the ACFs used in the CAM version two reasonable?

The Annual Charge Factors (“ACFs”) used in the CACM are, in the aggregate, too low to effectively capture the annual costs expected to be incurred by ACS given the investment levels estimates by the CACM.

To analyze the reasonableness of the ACFs, ACS calculated the overall ACF value by dividing the total annual cost estimated by the model by the total investment predicted for the baseline greenfield solution set. This calculation yields an overall ACF of 22.78%, which is much lower than the traditional expected ratio value of greater than 30%. For example, the corresponding ratio in the FCC’s hybrid cost proxy model (“HCPM”) for Anchorage Telephone Utility was 37.39%.⁹ If the current ACFs are adopted, the difference between the traditional expected ratio value and what is proposed under the CACM must be accounted for in reduced obligations under Connect America Fund Phase II relative to the price cap carrier’s reduced ability to meet these obligations resulting from the lower ACF.

The CACM model functions by first estimating total investment required to provide broadband service and then calculating total cost by applying cost factors to the estimated investment. As a result, using the ratio of total cost to total investment incorporates all costs – operating, non-operating and capital – that provides a complete picture of the costs estimated for

⁸ Again, without access to the underlying spreadsheet, analyses, and calculations used for switching, ACS does not know where or how the proposed switching input values in the Capex V9 file were derived.

⁹ The run of the HCPM that produced these results was based on HCPM version released December 18, 2001. Please see <http://transition.fcc.gov/wcb/tapd/hcpm/welcome.html>, file download HCPM doc.zip, History file for reference to this release.

a given level of investment. The above comparison shows that the CACM ratio of total cost to total investment is for lower than the current model used by the FCC to estimate federal support.

In the CACM, only the cost factors designed to recover capital costs incurred in providing broadband services are included in filed labeled “ACF” in the input files available with the model. For this reason ACS now takes the opportunity to address the capital cost inputs currently used in the model. Capital costs may be divided into two categories: depreciation expenses and the return to capital. The CACM currently uses the Commission’s safe harbor ranges for the economic life and salvage value inputs required to estimated depreciation expense. While there is a valid rationale for using safe harbor ranges, the values used are in excess of fifteen years old and require review to ensure they are able to capture the increased pace of technological obsolescence in the industry, especially with regard to electronic equipment.

The capital cost components raise other concerns, particularly that the current capital cost values used in the CACM are not representative of the actual costs a company incurs to attract and maintain capital balances. ACS faces strong competition in many of its service territories from GCI for long distance, wireless, and cable television services. GCI has benefitted from the previous regime of universal service support, using that support to help bring its landline market shares greater than 50% in ACS’ larger study areas. This competition, coupled with declining access lines and revenues, continues to increase ACS’s business risks. This increased risk is not reflected in the capital cost factors used in the CACM with only a 9.7% cost of equity and a 9% cost of money.

The Bureau asserts that the 9% cost of money used in the CACM is consistent with a proposal of the ABC Coalition and is higher than the rate advocated by the American Cable Association. Similarly, the Commission presents a preliminary analysis in the Further Notice of

Proposed Rulemaking portion of the *USF/ICC Transformation Order* with regard to the allowed rate of return for non-price cap LECs, suggesting that the authorized interstate rate of return should not exceed 9%.¹⁰ However, this preliminary determination ignores the actual market conditions faced by ACS and focuses only on the reduction in the cost of U.S. Treasury debt as well as ignores the ever increasing risks that LECs face. Although the yield on 10-year U.S. Treasuries has fallen since the last rate of return prescription, that does not necessarily mean the weighted average cost of capital (“WACC”) has declined and certainly not declined by a similar amount. Before any determination can be made on return to capital the validity of any estimates must be determined, not just for the cost of debt by proxy of U.S. Treasury yields but also for other determinants of a carrier’s cost of capital, especially the cost of equity and the debt ratio.

Although cost of equity and corporate debt tend to be correlated with Treasury yields over time, there are a number of reasons that this may not be the case. Due to changes that have occurred in the industry and the economy in general, it is likely that the risk for both the LEC’s equity and debt holders has increased significantly. There has been a substantial increase in competition, which had no meaningful presence at the time of the last rate of return prescription. Furthermore, there have been many monumental changes in the regulatory environment, which have increased uncertainty in the market. Competition and regulatory uncertainty are significant factors for increasing business risk and therefore increasing the cost of capital.¹¹ The risks faced

¹⁰ *USF/ICC Transformation Order*, ¶ 1057. This analysis was based on the fact that the average yields on ten-year United States Treasury securities has been over 450 points lower over the past six months compared to the yield over the six months prior to the 1990 effective date of the current subscription. *Id.*, ¶ 640.

¹¹ There have also been significant changes in the financial markets. Notably, the Federal Reserve has taken unprecedented actions in an attempt to stabilize financial markets in response to the financial crises beginning in 2007. For example, the Federal Open Market Committee has purchased large quantities of long-term Treasury Bonds in an attempt to reduce interest rates.

by insular carriers, such as ACS, under these market conditions and with these regulatory uncertainties do not justify a reduction in the cost of money value for purposes of determining universal service.

Conclusion

Any model used to provide support to price cap carriers must overall reflect the unique characteristics and costs of serving a study area, but the details of the model, such as modeling voice capability costs, must also reflect the serving area characteristics and the associated cost variances. Similarly, failure to adequately consider the risks faced by insular carriers compounds the model's inappropriateness as reflected in insufficient capital costs factors. Finally, problems with model transparency are highlighted when focusing on a specific issue, such as voice capability costs. Without transparency, problems in the model cannot be fully addressed or remedied.

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March 14, 2013

The Federal Reserve's actions of keeping interest rates at lower levels than would otherwise prevail will impact the historical relationship between the Treasury yields and the cost of a LEC's equity and corporate debt as it severs the ties between Treasury yields and corporate risk. With these ties severed it becomes impossible to determine the estimate changes in the WACC simply by observing changes to Treasury yields.